

US Agency for International Development Study of Innovative Practices in SME Finance



Case Study: BancoEstado (Chile) ***Applying Microenterprise Lending Practices to SME Lending***

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Submitted by Deloitte Touche Tohmatsu Emerging Markets, Ltd.
Contract No. PCE-I-00-99-00008-00
Task Order No. 1
Modification No. 1

Background

This paper is part of a six-study series that was conducted by the U.S. Agency for International Development (USAID), with assistance from Deloitte Touche Tohmatsu. The purpose of the study series is to identify and document innovative practices in SME financing. The information for this study was obtained from on-site visits and interviews with management of each of the organizations. The interviews were conducted by Suzanne Nolte Saunders of USAID's Economic Growth, Agriculture and Trade Bureau, Office of Economic Growth, with assistance from Teresa Mastrangelo of Deloitte Touche Tohmatsu for the Uganda and South Africa cases and from Maribeth Murphy of Deloitte Touche Tohmatsu for the Chile case. For more information on the overall series or to find the other study documents, please go to

http://www.usaid.gov/economic_growth/egat/eg/tech-financial

Acknowledgments

The authors of this case study wish to thank the management BancoEstado for their time and effort in supporting this work, both during the site visits and after, as well as the numerous other experts who generously contributed their time from USAID Missions, USAID projects, Deloitte Touche Tohmatsu local offices, and the local business community. Please see the list of interviews below.

List of Selected Interviews:

- Fernando Abarzúa Uribe, Agent, San Bernardo branch
- Isabel Guzman, Advisor, Micro and Small Lending Unit
- Inés Mollo Varela, Chief, Coordination Unit, Department of Small Enterprises
- Maria Soledad Ovando Green, General Manager, Microenterprises, BancoEstado
- Jaime Pizarro Tapia, Chief Executive, Banestado Microempresas (BEME)
- Enrique Roman Gonzales, Executive Director, Centro de Productividad Integral (CEPRI)

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TABLE OF CONTENTS

I. INTRODUCTION.....	1
II. BEME: PRINCIPAL SUCCESS FACTORS.....	2
III. UPSCALING BEME OR DOWNSCALING BECH?	4
IV. CONCLUSION.....	5

I. Introduction

Since 1985, Chile has launched economic reforms, which have resulted in admirable performance among other Latin America countries. However, economic inequality persists, and there has been no mass expansion of financial services towards micro-, small or medium enterprises in the urban and rural markets. BancoEstado (BECH), the wholly owned state entity, is one of the resources available to the Chilean government to correct this situation. BECH ranks among the three largest banks in Chile in terms of total assets. In 1998, the Bank administered more than 12 million savings accounts, accounting for 80 percent of all savings accounts nationwide, with an average balance per depositor of US\$290. Its branch network covers 83 percent of the poorest towns in Chile.¹

In 1996, with the increased competition in the Chilean financial system and the realization of a profitable market in the microenterprise sector, BECH authorized the creation of a subsidiary, BancoEstado Microempresa (BEME), to focus on microenterprise lending.² BEME commenced operations in 1997, and since then, has achieved phenomenal growth and performance. The portfolio of customers has been growing on a sustained basis, almost doubling from one year to the next, and with extremely low rates of loan delinquency (2.8 percent in 2000). As of December 2000, the total number of borrowers reached a level of 31,500, with an average loan size of US\$1,200. BEME's profitability has also been gradually increasing. In 2000, the return on assets was 15.6 percent, significantly above the 3.4 percent in 1998. Return on capital was 16.3 percent in 1999 and 4.1 percent in 1998.

Chile's commercial financing organizations include: three finance companies, the Corporación de Fomento de la Producción (CORFO), one second-tier bank, and 29 commercial banks. On the whole, the financial system is profitable, and has demonstrated capital sufficiency and high rates of financial efficiency; however, the liberalization of financial markets has not been completed. Moreover, special credit programs designed to serve priority sectors, such as micro- and small enterprises, at concession rates make up a negligible portion of the total volume of loans in the financial system. Regardless, these sectors are growing at astronomical rates in Chile and publicly the Government of Chile is encouraging credit to micro- and small enterprises.

Chile's financial regulatory framework is not conducive to entering the micro-lending market: minimum capital requirements for banks are US\$26.5 million and for finance companies US\$ 13.3 million. Aside from BECH and seven non-regulated financial NGOs whose impact on the market is negligible, two additional banks provide financial services to the microenterprise sector and represent BEME's primary competitors: Banco Santander and Banco del Desarrollo. The former is a Spanish-owned bank that entered the microenterprise market in November of 1995. Banco del Desarrollo is smaller than Banco Santander, but has been in the market longer, since 1983.

¹ Jorge Daly, 2001, *Banking to Serve Microenterprises: The Banestado Case*. The authors wish to thank Mr. Daly for sharing his report and his knowledge during the preparation of this case study.

² Microenterprises are defined as those with annual sales of CLP .1 to CLP 2,400; small and medium enterprises are defined as those with annual sales of CLP 2,401 to CLP 100,000. 1 USD = 746.042 CLP

The purpose of this case study is to highlight the successes that BancoEstado has made in microlending and contrast that with the challenges it faces in lending to the SME sector. It begins with a description of the factors and business practices that have been critical to BEME's success and then examines which of these practices BECH plans to replicate in carrying out its SME lending strategy. In the conclusion, a few considerations for the design of SME financing interventions by donors are listed. The case is based upon field interviews in Chile with BEME management and clients in July 2002. The data presented in the study draws from staff interviews, as well as from a report authored by Jorge Daly titled *Banking to Serve Microenterprises: The BancoEstado Case*.

II. BEME: Principal Success Factors

Many factors have contributed to the success of the microenterprise lending program of BEME, including favorable external environment (namely a stable and regulated financial sector, a relatively wealthier microenterprise sector, the availability of educated professionals, and government subsidies), semi-independent operating structure, effective marketing strategy, and strong information and risk management systems.

Semi-independent operating structure

BEME's autonomous operating structure is a critical element to its success. As a subsidiary, BEME sells to its parent organization (BECH) all banking services including deposits and loans. Moreover, BEME has access to BECH's enormous volume of savings and commercial branches. BEME has complete management autonomy and is free to design its own products, establish systems, and hire and train its own staff. BEME operates as an independent cost center with oversight from a board of directors. It is a relatively flat organization that operates in a decentralized manner.

The benefits of this operating structure for a microlending program are numerous. First, there are the financial benefits: start-up or initial investment costs are negligible; little or no money is spent on capturing deposits since loan money is available through the parent; and parent and subsidiary can share some overhead costs. Second, BEME has tremendous market presence and reach through BancoEstado's trustworthy reputation and nearly 300 bank branches. In addition, BEME's customers have access to a broad range of commercial bank products through BECH. Third, the current structure permits BEME to operate in a streamlined manner and with flexibility. For example, autonomy from the Bank's core commercial lending activities means that a credit committee for loan approval does not exist, allowing for a faster turnaround of loan applications. Furthermore, BEME's mandate of self-rule permits it to be flexible when acquiring services. Management can either outsource services, such as Human Resources and Management Information Systems, or share the costs of these services with BECH. Such flexibility allows for better services and/or lower costs.

Finally, the subsidiary approach to microlending allows business risk to be shared by the parent and the subsidiary, which effectively lowers transaction costs. As previously

indicated, BEME sells financial services (loans and portfolio management among other services) to BECH. BEME's income consists of commissions it receives from BECH for interest received; its assets are mostly accounts receivable from BECH, and its liabilities are reserves and withholdings. The liabilities do not contain public deposit accounts, as BEME does not take savings from the public nor issue bonds or certificates of deposit. The funding for its loans comes entirely from capital contributions made by BECH.

Effective marketing strategy

BEME's mission is to make lending to microenterprises bankable or profitable. It has accomplished this through a carefully designed, specialized, leveraged and segmented approach to marketing. First and foremost, BEME's management has clearly defined and segmented the marketplace -- by business characteristics and geography -- and recognizes the business and cultural uniqueness of microenterprises. Next, BEME uses the extensive branch network to service microenterprises. BEME has selected 40 branches through which to operate its microlending program. These branches were selected after careful analysis of the profit-making potential of the market. In each of these branches BEME established separate commercial platforms where it operates, designed distinct banking products and practices, and hired staff with microenterprise experience. The specialized nature of microenterprise lending is reinforced through training, specific technology applications, geographic or local business plans, and customer surveys.

Further, BEME's marketing strategy is demand-driven. The local business plan is the principle vehicle used to carry out the Bank's marketing strategy through its branch network. The Plan is developed annually to pick up market signals and identify market niches in order to design and market financial products in each geographic area. Moreover, it is a tool to implement BEME's marketing strategy. In addition, a key factor in BEME's marketing strategy has been to leverage the market image of BECH as a serious, trustworthy institution offering security to its customers. BEME conducts regular marketing campaigns with clear messages, emphasizing its relationship to BECH and underscoring its cultural roots with the target market. Finally, direct customer contact is possibly the most important element of the marketing strategy. Direct contact is made with customers through visits to BECH's branch offices for traditional bank services and in fairs, special events, and activities of the mobile bank.

Strong information and risk management systems

The small scale of operation, unstable performances, and heterogeneous nature of microenterprises are the major sources of high credit risks of any microlending program. Therefore, basic information such as clients' current and past delinquencies or defaults, current outstanding balances, and credit histories of guarantors and co-signers, is needed to reduce credit risk. Credit information services markets are generally non-existent or in their infancy in developing countries, and if developed, are generally quite fragmented. This is not, however, the case in Chile. Chile has abundant, sophisticated and extremely well integrated sources of business information. The principal source of information for BECH and BEME is the Internal Tax Service (SII), which bases its data on income and

VAT statements prepared by businesses. Other sources of data include: MIDEPLAN, the Banking and Financial Institution Supervisory Authority and the SERNAM. Information from these sources is fed into the Central Database (BDC). The BDC provides the banking institutions with cumulative information, by business size, sector and market segment, among other criteria.

BEME's internal information systems are state-of-the-art. With the aid of a computer service company, BEME has developed its APER-BEME system to standardize evaluation criteria for each risk, determine the likelihood of loan repayment, and automatically update credit policies. BEME also installed the VOS (Via Operadores de Sistemas) technology to improve operating efficiency and service quality, and a portfolio monitoring system that enables each commercial executive to manage his/her loans on a day-to-day basis. These systems have greatly reduced transaction costs and enhanced the management control and risk control of the microenterprise lending program. BEME relies heavily on its information systems (external and internal) to be competitive in the marketplace. These systems, in addition to strong account management training, enable each account executive to manage a portfolio of 650 loans, which is projected to increase to 850 loans per executive by the end of 2002.

III. Upscaling BEME or downscaling BECH?

By all accounts, BancoEstado has been successful in downscaling its lending operations to microenterprises.³ However, the Bank has had only limited success in its SME lending program. The SME program, which was launched about 10 years ago, continues to operate within BECH's traditional lending structure. In view of the fact that serving this market is a key policy objective of the Government, BECH is presently reviewing its SME lending program and developing a new strategy. While the Bank recognizes the differences between lending in the micro- and SME markets, the Bank intends to adopt many of its successful practices from its microlending program to improve its SME lending program. Drawn from interviews with BEME management, it appears that the Bank (BECH) intends to penetrate the SME market through its existing structure under BEME (upscaling BEME), rather than penetrate the market "downward" through BECH.

While Chile's SME sector is significant, it is widely recognized that national and foreign banks service the sector poorly. The general view in the business community is that the government and the banks have not met their promises of improving SME access to credit. In 2000, SME business units constituted about 17 percent of formal or registered businesses, 25 percent of employment and 20 percent of national sales.⁴ The sector's economic impact is relatively significant. Further, it is estimated that approximately 70 percent of SMEs have existing bank relationships, leaving a wide gap in the market. The leading banks in SME lending are: Banco Chile and Banco Santander. BECH has historically treated SME lending in the same manner as medium and large enterprise lending without recognizing the need for specialized services. Because of the Bank's

³ BEME is the largest microenterprise lender in Chile, holding 45 percent of the market.

⁴ Daly, Jorge. 2001. *Banking to Serve Microenterprises: The Banestado Case*. Bethesda, Maryland: Development Alternatives, Inc.

positive experience with BEME, the economic impact of the SME sector, and clear opportunities in the marketplace, SME lending is taking on greater importance in the Bank's portfolio.

The Bank's and BEME's goal is to increase its market share from six percent to ten percent over the next two years. Management views the following as the key obstacles in expanding its market share of SME lending: (1) cumbersome SME credit process; (2) poor and inconsistent accounting practices among SMEs; (3) basic distrust of free enterprise among the Bank's elite, and (4) Bank culture of nepotism and cronyism, which prevents the best talent from coming forth.

BEME's management plans to overcome these obstacles by applying similar tactics to those used to develop its microenterprise lending market. In particular, BEME will focus on making the SME lending program profitable. Management believes this can be achieved by replicating many of the same strategies used to develop its microlending market; namely, (1) use existing branch network to locate SME lending units in branches with high demand; (2) train staff in uniqueness of SME lending; (3) provide specialized services and products; and (4) tailor technology to meet the specific requirements of SME lending. The Bank anticipates that to advance its position from sixth largest SME lender in Chile, it will have to compete with other commercial banks by expanding its services to include on-line banking, adopting a competitive pricing structure, and leveraging its integrated structure with BancoEstado.

IV. Conclusion

BancoEstado is still in the process of institutionalizing the lessons learned from their successful microlending business to serve SMEs. Those lessons might be listed as follows:

- Volume is key to profitability. Determination of volume requires solid study of the market and then, careful selective of the markets entered
- Keep transaction costs as low as possible, use pre-existing infrastructure such as both physical and market reputation
- Recognize that SME financing requires specialization of human resources, technology and products
- Information and technology are critical, resulting in lower risks and increased speed of transaction processing

In addition, we can learn from BEME's experience in terms of how donors can support an increase in focus by banks to finance SMEs, as listed below:

1. There is a general belief that only private sector innovations have merit. The BancoEstado case, on the other hand, does show that state-owned banks may in fact has some advantages in accomplishing a change in strategy to focus on smaller borrowers. These are mentioned above, including lower cost of funds and streamlined operations to reduce transactions costs (assuming high transactions

costs are a barrier to SME lending) and access to technology as a way to mitigate risks. In considering a trade-off between, for example, a donor-funded direct lending program and a subsidy program, through a state-owned bank, donors may find there are less market distortions and more creativity and innovation by facilitating the intervention in SME finance by the state-owned bank. This presumes, of course, that rigorous performance measures for sustainability and profitability are put in place over time. (See also in this series the case study on the American Bank of Kosovo, a USAID-owned bank.)

2. The level of development of the Chilean economy, and in particular the availability of advanced technology, facilitates the lending process. As a part of future SME lending projects, USAID Missions and other donors may wish to support the development of tools and methodologies, such as credit scoring, credit classification and statistical techniques as well as use of laptops and handhelds to make the lending process efficient.
3. Upscaling from microlending to SME lending may be easier than downscaling from traditional lending. Continued study of the success rates of these two approaches may be worthwhile

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